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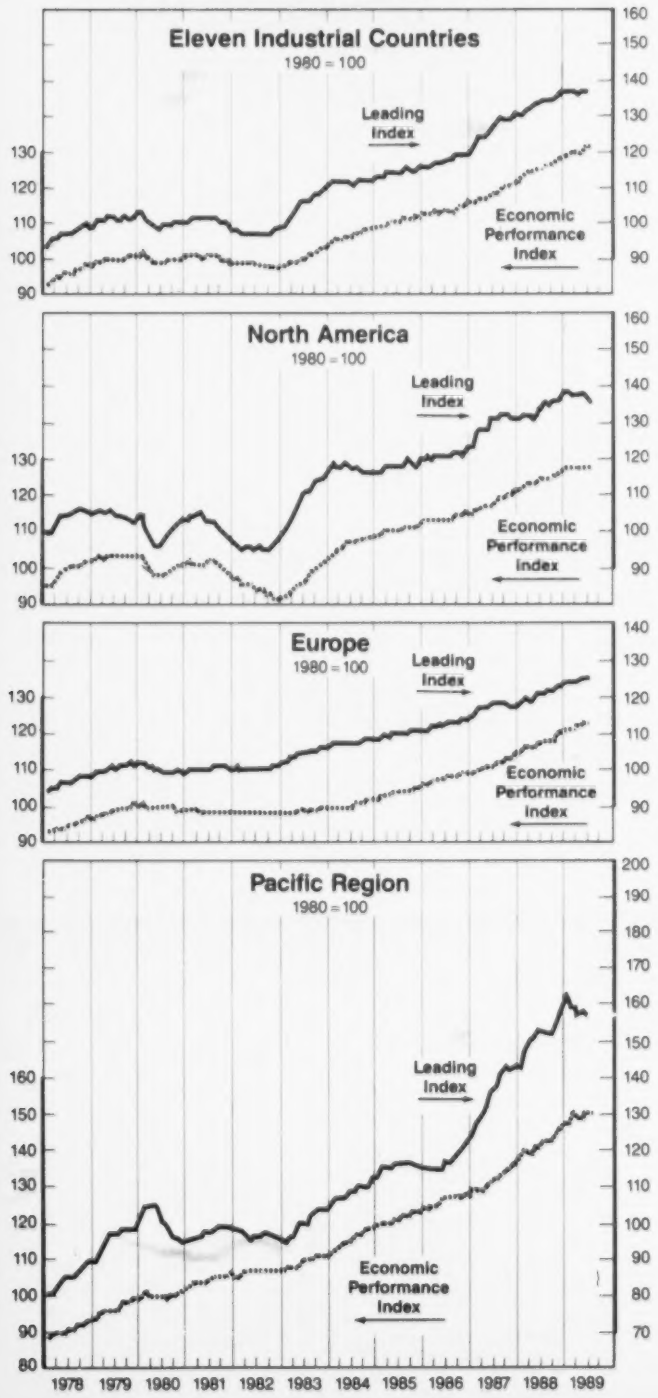
The Conference Board

Economic and Business Environment Program

International Economic Scoreboard

A Quarterly Report from The Conference Board **Fourth Quarter 1989**

WORLD BUSINESS CYCLE



For the first time since the stock market crash in 1987, the indexes that track the global business cycle are reporting a message other than "onward and upward." The latest data for the 11-country leading index show a pronounced leveling off since the beginning of the year. This signal should not be magnified into a forecast of an economic downturn, however, because meaningful declines in the leading indexes remain difficult to find. What the numbers do suggest is a distinctly slower pace of economic advance.

All three major regions of the world show the same pattern. When we go further and examine the data country by country, we find the signs of slowdown to be fairly widespread. Only West Germany (by a wide margin) and France (narrowly) have leading indexes that are advancing faster than their long-term trend rates of growth. Taiwan's leading index is still moving higher at a hefty 8 percent pace, but that only matches the country's long-term growth rate. Italy and New Zealand, both with 2 percent growth rates, also match their historical pace.

The other half-dozen countries, including the United States and Japan, show more limited growth in their leading indexes. (As discussed previously in the *Scoreboard,* the Japanese data are distorted by the impact of the new value-added tax imposed last April 1; this raises a question whether the economic outlook in Japan is actually as lackluster as the leading index suggests.) The only minus sign is for Australia, where the leading index is declining at a 3 percent rate.

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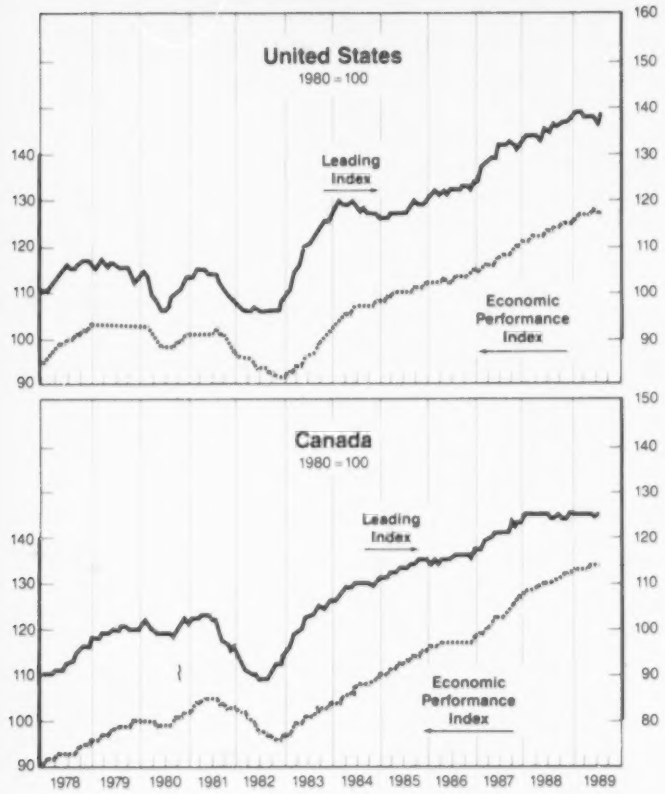
NORTH AMERICAN COUNTRIES



The U.S. leading index, which has been flat since the beginning of the year, dipped a couple of points in July and then rebounded smartly in August. Most of the August bounce-back can be traced to the consumer-credit and capital-goods-orders components, which were also making up ground lost in earlier months. Preliminary indications for September suggest another modest gain for the leading index.

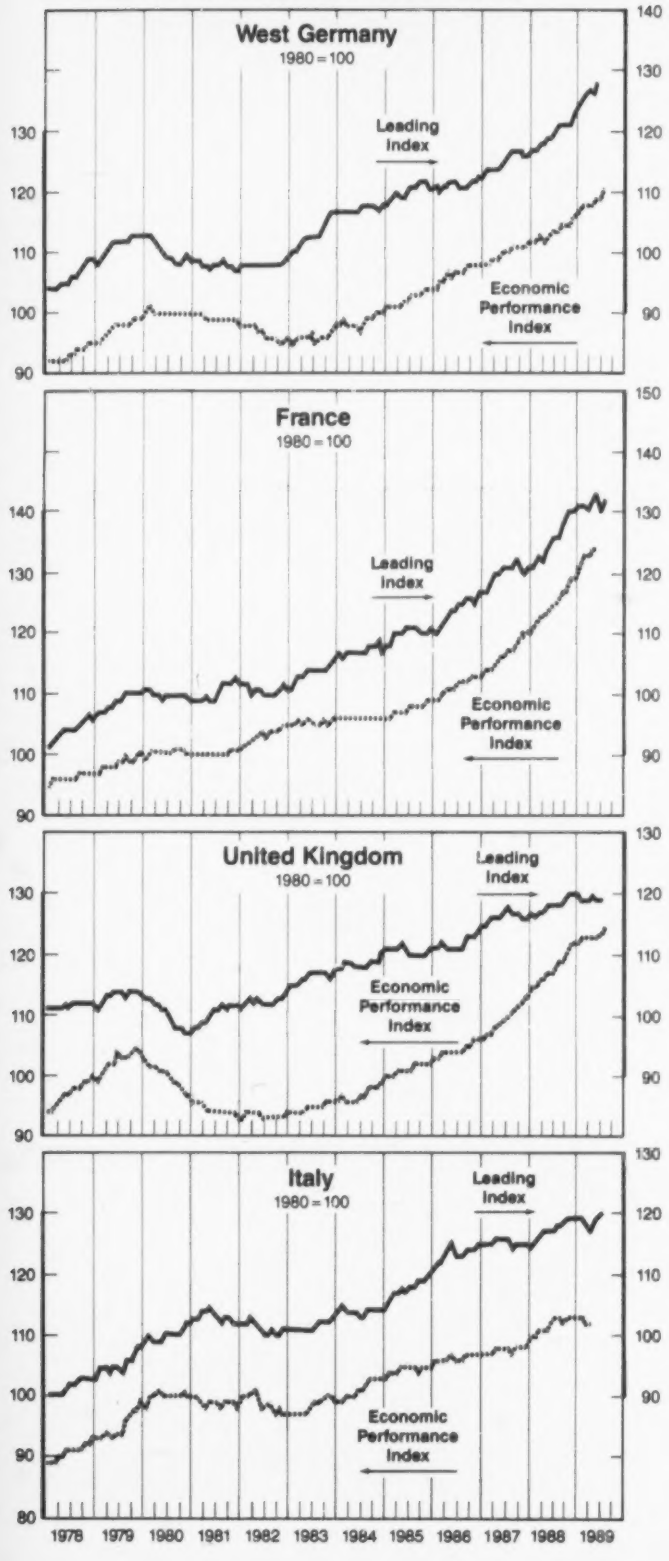
The Canadian leading index regained in July the small declines recorded in the two previous months. The growth rate for the leading index is zero and, in fact, the index has been flat for a year and a half—a good long stretch. Nevertheless, the economic performance index continues to move ahead—albeit reluctantly.

Summary Of Growth Rates, Eleven Industrial Countries

	Ten-year Growth Rate	Indexes of Economic Performance Growth Rates*			Leading Business Cycle Indexes Growth Rates*			Current Reading on the Cycle	Latest Month Covered
	1976-86	6 mos. ago	3 mos. ago	Latest month	6 mos. ago	3 mos. ago	Latest month		
	annual rates, percent								
Eleven countries	3	6	5	4	7	4	1	Expansion continuing, leaders weak	July
Ten countries excl. U.S.	3	6	5	4	8	5	2	Expansion continuing	July
North America (2)	3	4	4	2	5	2	-2	Expansion continuing, leaders weak	July
Europe (4)	2	6	5	4	6	3	3	Expansion continuing	July
Pacific Region (5)	4	7	5	5	13	7	1	Expansion continuing, leaders weak	July
United States	3	5	4	3	4	2	2	Expansion continuing	Aug.
Canada	3	4	3	2	1	0	0	Expansion continuing, leaders weak	July
West Germany	2	5	4	6	7	8	8	Expansion continuing	Aug./July
France	2	8	8	7	6	5	3	Expansion continuing	June/Aug.
United Kingdom	2	7	5	5	4	1	0	Expansion continuing, leaders weak	Aug./July
Italy	2	3	1	-1	3	-1	2	Cyclical direction uncertain	Apr./July
Japan	4	7	5	4	14	7	1	Expansion continuing, leaders weak	July
Australia	3	11	13	11	3	0	-3	Expansion continuing, leaders weak	July
Taiwan, R.O.C.	8	6	6	6	8	6	8	Expansion continuing	Aug.
Korea, R.O.K.	7	8	4	6	9	5	2	Expansion continuing	July
New Zealand	2	1	2	-2	4	6	2	Upturn developing, with a setback	May/July

* Ratio of current month's index to average index over the preceding 12 months, expressed as a compound annual rate.

EUROPEAN COUNTRIES



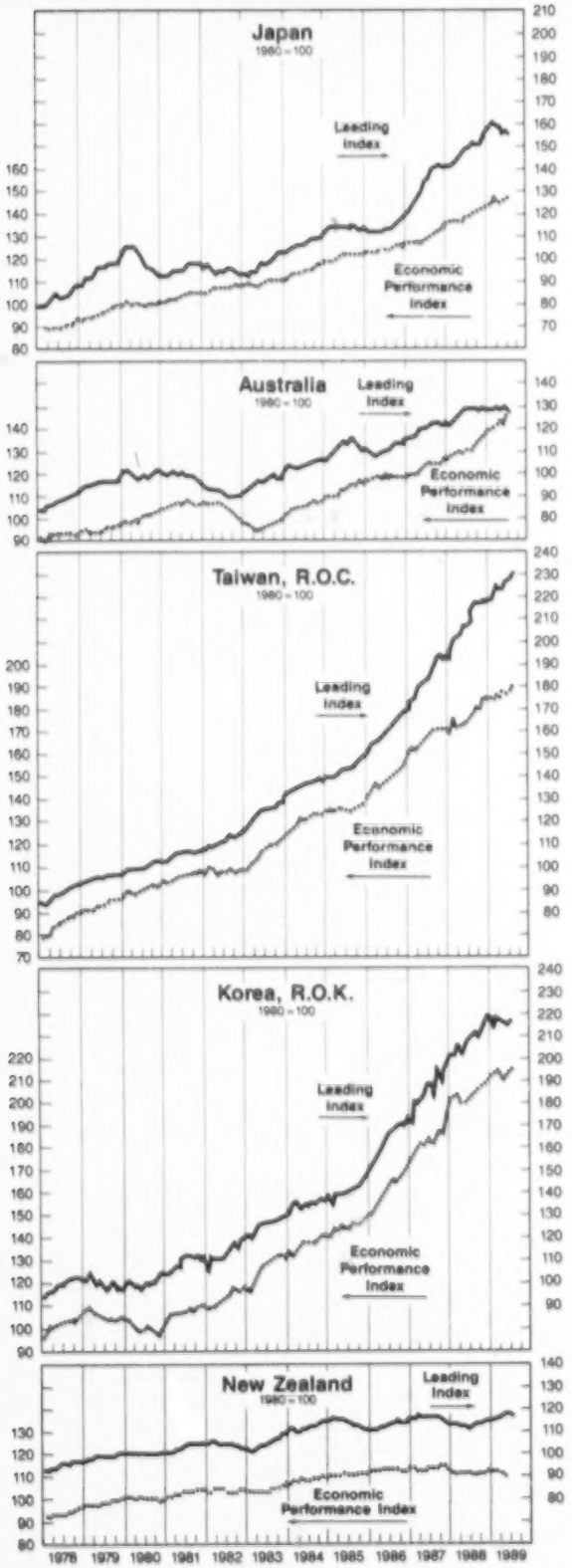
The West German numbers show the brightest outlook among all eleven countries. Both the leading and performance indexes are advancing in a spirited fashion—at 8 percent and 6 percent respectively.

In France, the leading index rebounded nicely in August following a surprising dip in July. The 3 percent growth rate in the index is encouraging but only moderately so.

The United Kingdom's indexes are something of an enigma. The economy continues to advance rather vigorously—the performance index shows a growth rate of 5 percent—despite a leading index that has shown no growth at all for nine months.

Italy's economic outlook improved slightly this month, as the leading index inched forward to a new high. Nevertheless, with the growth rates at 2 percent for the leaders and -1 percent for the performance index, the Italian data continue to be unimpressive and irresolute.

PACIFIC REGION COUNTRIES



The outlook for Japan appears to have soured dramatically since last report. Unfortunately, however, the data are badly obscured by two events: First, the method by which the indexes are calculated has been revised (to eliminate the excessive short-term fluctuations that often would arise from certain component series). And second (as anticipated in previous reports) the impact of the new value-added tax imposed in Japan last April 1 made earlier data look unduly favorable while depressing the subsequent numbers. Currently, the performance index shows steady growth, and the leading index seems to be leveling off, but how much attention we should pay to the leading index is a puzzle.

The Australian performance index tells us the economy is growing like an explosive weed. Yet the leading index is not at all consistent with a rapid advance: It has been flat for a year and, in fact, dropped two points in July.

The indexes for Taiwan, R.O.C., continue to rise steadily at an average pace (average for Taiwan, but extremely vigorous for most other countries). Taiwan's current growth rates—6 percent for the performance index and 8 percent for the leaders—are identical with West Germany's; they are the two countries, just now, with an unequivocally positive outlook.

Korea is another economy, along with Australia, France and the United Kingdom, where the leading index growth rate is moving at a pedestrian pace (2 percent for Korea) while the performance index continues to advance nicely.

New Zealand (charted here for the first time) had appeared to start on a moderate cyclical recovery in late 1988. New data, however, cast doubt on this conclusion, because they show a decline in the economic performance indexes in April and May. This drop is difficult to fathom, because the decline had *not* been heralded by the leading indexes—not even by a hesitation in the growth rate. But then, in addition, the leading index stumbled in July. The puzzle, then, is how seriously to take these latest numbers.

WORLDWIDE ECONOMIC SLOWDOWN AHEAD

As the first part of this *Scoreboard* shows, the global business-cycle expansion is slowing down. In the United States, after vigorous growth of 5.4 percent in 1987 and a sturdy 3.4 percent in 1988, the economy has settled down to an annual rate of advance of 2.5 percent in the second and third quarters of this year. This same pattern of continuing but slowing expansion is evident also for most of the other major industrial countries. With few exceptions—notably West Germany and Taiwan—the *Scoreboard's* leading indexes support the expectation that the slowdown will persist in the months ahead.

Economic forecasting is a dangerous occupation, hazardous to an economist's professional reputation. Yet prediction is inseparable from life, and our choice is not whether to forecast or abstain from it, but whether to rely on "hunches" or on lessons carefully distilled from experience. One of the lessons economic forecasting history teaches us is that very few individuals are consistently able to forecast more accurately than the consensus of a group of professional forecasters. The "forecasting batting average" of the consensus is virtually always superior. In this *Scoreboard* we examine a multicountry record of consensus forecasts since 1982. These are forecasts of economic output (real GNP or GDP) and inflation (the consumer price index, CPI) for the United States, the United Kingdom, West Germany, and Japan.

The historical record was compiled from *Blue Chip Economic Worldscan*, which regularly published projections of year-to-year percentage changes in the GNP and the CPI for the major countries. (Similar data are now provided by *Globescope*, Glen Carbon, Illinois.) Over thirty prominent forecasters from many countries regularly participate in the survey from which these consensus forecasts are compiled.

How good is this group's forecasting record? To answer that question you need a standard or benchmark against which to compare the accuracy of their forecasts. One widely used comparison is to match the group's forecast against a "naive extrapolation," which is a forecast generated by assuming that next year's change will be the same as this year's.

Here, again, we find that on average the consensus forecast is almost always superior to the extrapolation benchmark. For output growth, the average error for the consensus was 0.9 percentage points, substantially lower than the 1.6 points for the benchmark. For inflation, the margin is narrower: 1.2 vs. 1.4 percentage points. Looking at the record country by country, the forecasters beat the benchmark on output in all four nations, and on inflation in three of the four. Only in Japan were the extrapolative forecasts of inflation more accurate.

The evidence above provides strong support for the conclusion that a professional consensus is more accurate than a naive procedure. But how would the errors from the consensus forecasts compare with those associated with the use of leading indicators to forecast magnitudes of change in output and prices? It is commonly said that the leading-index approach is helpful in forecasting business-cycle turning points but has nothing useful to say about the magnitude of expansion or contraction. Not so. Researchers at the Columbia University Center for International Business Cycle Research (CIBCR) recently conducted experiments to test the usefulness of the leading indexes in predicting year-to-year changes in real output.

One such test used the growth of Columbia's "long leading" index to forecast changes in U.S. economic output. This test showed an average error of 0.9 percentage points for the period from 1969 to 1988. This is a slight improvement on the 1.0 percentage point error that is typical for the consensus of professional forecasters.

Another test that was made was based on inflation forecasts. It used the Columbia leading inflation index to forecast year-to-year percent changes in the U.S. consumer price index from 1969 to 1988. This test disclosed an average error of 1.0 percentage point, again slightly better than the 1.1 point error in the October consensus forecast of the CPI made by the Blue Chip Economic Indicators Survey since 1983. In both cases, then, the U.S. leading indexes proved themselves to be useful forecasting tools.

The accompanying table provides information on some preliminary work on the forecasting accuracy of the Japanese, West German, and British leading indexes with respect to changes in real gross domestic product. (As yet, leading inflation indexes are not available for these countries, so we limit this analysis to output forecasts.) A simple regression for the 1982-1988 period that uses the preceding October's smoothed rate of growth in the leading index as the explanatory variable is employed to forecast next year's GNP. For Japan this method produces forecasts with an average error of 0.5 percentage points. This compares with an average error of 0.9 percentage points for the consensus of professional forecasters. For the United Kingdom and West Germany the comparable statistics are 1.0 percentage points for the British leaders

vs. 0.7 points for the consensus, and 0.7 percentage points for the German leaders vs. 0.9 points for the consensus. Thus in three of the four countries—the exception is Britain— use of the leading indexes tends to improve the forecasts—not every year, of course, but more often than not.

Looking Ahead

What are the prospects for 1990? As noted earlier, the global business cycle appears to be headed for a slowdown in 1990. In the United States, the CIBCR long leaders are suggesting a growth of real output of 2.6 percent for next year, which is just about the same as its current growth rate and slower than last year. The consensus forecast, however, is a bit more pessimistic; it calls for 1.9 percent growth in the U.S. in 1990. In Japan, growth in real output is currently running above six percent. The Japanese leading index (assuming it continues for the next couple of months to look the way it does now) is predicting a slowdown to a 3.7 percent advance in 1990, whereas the consensus predicts a more optimistic 4.8 percent. For West Germany and the U.K., the leading indexes suggest growth of 3.9 percent and 3.5 percent respectively, while the consensus forecasts for 1990 are for growth of 2.9 and 1.6 percent respectively. In all four countries, then, the forecasts of next year's output, whether they come from the leading indexes or from the professional forecasters, call for slower growth to continue in 1990.

One final point: What impact can we expect these slower growth rates to have on inflation? Well, we shouldn't expect too much, because the projected slowdown in output growth is not very sharp—we're not talking about anything nearly as sharp as a recession, for example. But it is reasonable to expect inflation rates to subside somewhat over the next twelve months. Numerous economic studies have confirmed that in all four countries subpar economic growth experience has led to noticeable declines in the rate of inflation.

AVERAGE FORECAST ERRORS

(percent deviations in year-to-year forecasts, calculated without regard to sign)

	Output			Inflation		
	Consenus	Extrapo-lation	Leaders	Consenus	Extrapo-lation	Leaders
United States	1.0	2.6	0.9	1.1	1.8	1.0
United Kingdom	0.7	1.1	1.0	1.1	1.8	-
West Germany	0.9	1.2	0.7	0.9	1.0	-
Japan	0.9	1.4	0.5	1.3	1.0	-
Average, four countries	0.9	1.6	0.8	1.2	1.4	-

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